CANDRIAM
A NEW YORK LIFE INVESTMENTS COMPANY

How to take advantage of inefficiencies created by index managers

60 seconds with the fund manager

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Marketing communication

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Emmanuel Terraz, Global Head of Absolute Return & Quantitative Equity, explains to us how the explosion of the index management market can create investment opportunities for managers who can take advantage of of temporary market inefficiencies.

What is the first observation that led you to develop an index arbitrage strategy in 2003?

Back in 2003, we noticed that index arbitrage was really starting to take off, and this trend has only grown stronger since then.

Today, on average in the developed markets where we focus our attention, index mana gement has grown in scale and scope. The movement has mainly been driven by pension funds allocating capital to the various asset classes at lower cost.

From that standpoint, we were firmly convinced that playing on index readjust ments – taking short positions in names being removed or long positions in names being added during the quarterly index rebalances – would generate opportunities for attractive returns.

How has the strategy's potential evolved in recent years?

Index arbitrage volumes have swelled over the past ten years, in pace with the rapid development of the index tracking industry. We provide liquidity to index managers whenever they have to replicate the read justments by purchasing incoming securities and selling outgoing securities.

These transactions generate substantial additional volumes in these specific secu rities, thus creating price inefficiencies. The addition of a stock to the S&P500, for example, can generate investment flows of some $10 billion and approximately €1 billion on the Euro Stoxx 50. As a conse quence, this universe offers a very deep market.

60 SECONDS
WITH THE FUND MANAGER

Our strategy, however, is to allocate only 30% of assets(1) to arbitrage, with the rest of the portfolio consisting of cash instruments. We are perfectly capable of managing hundreds of millions of euros in order to maintain sufficient room to manoeuvre, but we also want to keep a reasonable amount invested to ensure a satisfactory return.

You wanted to gradually add other strategies to your historic core strategy, index arbitrage. Why did you decide to diversify?

It's true, we set up corporate action and relative value arbitrage strategies. From the beginning our approach combined qualitative and quantitative analyses. A purely qualitative approach, based on inter views with corporate management, gives a sense of the company's business model. For its part, a quantitative model optimised with multiple inputs can give you a multitude of data, but doesn't provide you the required level of understanding in the company lifecycle. So in addition to quantitative backtesting, we also try to get a handle on the rationale of index readjustments. They are often driven by corporate actions (mergers & acquisitions, IPOs, spinoffs, bankruptcies, etc.), which automatically spark largescale buy/sell flows.

It's helpful to understand how these corpo rate actions work and how to take advantage of them. With a public exchange offer, for example, you see arbitrage between the target and the buyer based on the terms of the exchange: fair value is defined based on the likelihood that the exchange will go through. Corporate action arbitrage, which involves identifying securities whose price will be impacted by a specific event, follows on naturally from that.

Another natural step forward is to look at relative value through pair trading, or arbitrage between two companies with the same business via a short position offset by a long position in order to remain market neutral. The goal is thus to benefit from mean reversion on two highly correlated assets. Our observation of additions/deletions within the indices, and their timing give us very good indications on the trends affecting various sectors and various companies, and this has enabled us gradu ally to implement this strategy.

What sets your approach apart from other hedge fund managers which rely on the same strategies?

As regulations have evolved, banks have slightly reduced their proprietary trading, but arbitragists have stepped in the hedge fund universe, so volumes have been maintained.

In the hedge fund universe, some funds based their performance on lowmargin arbitrage strategies boosted with leverage. That's not how we operate. We focus on daily liquidity in a UCITS framework, withlow volatility. The target is to achieve an absolute return ahead of Eonia.

(1) Data provided solely for information purposes and likely to change over time.

To reach our target, we combine a cash bucket invested in shortterm money market instruments (about 70%[2] of the port folio's assets) with an active investment bucket consisting of discretionary arbitrage strategies in equities and indices. More importantly, we are equity market neutral so we are not impacted by the market environment, because our long and short[3] positions are equally weighted (about 20%[4]): net market exposure cannot exceed 10%[5] and has often been lower than 1%[6] since inception. Finally, the portfolio is highly diversified, with each individual position usually weighting at less than 1%[7] of the portfolio.

(2) Data provided solely for information purposes and likely to change over time.
(3) A long position is a buyer's position, as you are betting on the value of the share to rise. A short position is a seller's position because you expect the price to fall in the future.
(4) Data provided solely for information purposes and likely to change over time.
(5) Data provided solely for information purposes and likely to change over time.
(6) Data provided solely for information purposes and likely to change over time.
(7) Data provided solely for information purposes and likely to change over time.

The main risks of the strategy are:

- **Risk of capital loss**
- **ESG Investment Risk**
- **Sustainability Risk**
- **Equity risk**
- **Interest rate risk**
- **Credit risk**
- **Currency risk**
- **Liquidity risk**
- **Derivative risk**
- **Counterparty Risk**
- **Arbitrage risk**
- **Volatility risk**
- **Emerging market risk**

ESG Investment Risk: The non-financial objectives presented in this document are based upon the realization of assumptions made by Candriam. These assumptions are made according to Candriam's ESG rating models, the implementation of which necessitates access to various quantitative as well as qualitative data, depending on the sector and the exact activities of a given company. The availability, the quality and the reliability of these data can vary, and therefore can affect Candriam's ESG ratings. For more information on ESG investment risk, please refer to the Transparency Codes, or the prospectus if a fund.